IN THE

Supreme Court of the United States

October Term, 1939.

No. 146.

JOSEPH T. HIGGINS, Collector of Internal Revenue for the Third District of New York,

Petitioner,

v.

JOHN THOMAS SMITH,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT

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INDEX.

Table of Cases Cited:

PAGE

OTHER AUTHORITIES CITED:

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Opinions Below.

In the District Court, the case was submitted to a jury and judgment upon the verdict was entered May 10, 1938 (R, 33-4). The opinion of the Circuit Court of Appeals (R. 767-9) is reported in 102 Fed. (2d) 456.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered March 29, 1939 (R. 770). The petition for certiorari was filed June 28, 1939 and was granted

October 9, 1939. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

Whether the taxpayer is entitled to deduct a loss arising from the sale of securities to a wholly owned corporation.

Statutes Involved.

The statutes involved are set forth in the Appendix, *infra*, pages 33-5.

Statement.

Proceedings Below.

This case is here on certiorari to review a decision of the United States Circuit Court of Appeals for the Second Circuit reversing a judgment entered in accordance with the verdict of a jury returned in the Southern District of New York in an action brought for an income tax refund.

On March 11, 1935, the Commissioner of Internal Revenue notified the taxpayer of the determination of a deficiency and penalty for the year 1932 (R. 18-9, 183-5). The deficiency was based on the disallowance of losses arising from the sale of securities to Innisfail Corporation and to the taxpayer's wife. The taxpayer paid the alleged deficiency and filed a claim for refund. Upon the Commissioner's failure to rule on the claim within six months, the taxpayer instituted this action. At the conclusion of the testi-

mony, both sides moved for a directed verdict and both motions were denied (R. 158-9). The jury found for the taxpayer on the issue of the sale to his wife and on the issue of the penalty but found for the Collector on the issue of the sale to Innisfail Corporation (R. 175-6). Judgment for the taxpayer was entered in the sum of $28,935.49 (R. 17).

The taxpayer appealed to the Circuit Court of Appeals from that portion of the judgment which denied recovery for the loss asserted on the sale to Innisfail Corporation (R. 307-8). The Collector appealed from that portion of the judgment which granted recovery for the loss asserted on the sale to the taxpayer's wife but raised only the question of the proper cost basis of the stock sold. The Collector did not appeal from that portion of the judgment which granted the taxpayer recovery of the penalty (R. 338).

The appeal and cross-appeal by the taxpayer and the Collector from the adverse portions of the judgment were heard by the Circuit Court of Appeals in January, 1939. The court reversed the judgment of the District Court on both issues, holding that on the undisputed evidence the taxpayer was entitled to the loss on the sale to Innisfail Corporation and was not entitled to the cost basis he reported on the sale to his wife (R. 338-40). The Court of Appeals first ordered judgment to be entered in accordance with the opinion but, upon motion of the Collector, amended its opinion and ordered a new trial (R. 342-6).

The Collector petitioned this Court for a writ of certiorari on the ground that the Court of Appeals erred in holding the taxpayer entitled to the loss arising from the sale to Innisfail Corporation. The taxpayer cross-petitioned for certiorari on the ground that the Court of Appeals erred in remanding the case for a new trial instead of ordering the entry of judg-

ment. The taxpayer's petition also sought review of the Court of Appeals ruling on cost basis. The taxpayer's petition was denied on the same day that the Collector's petition was granted.

Facts.

Innisfail Corporation (hereinafter called "Innisfail") was organized under the laws of New Jersey in 1926 (R. 19, 185-90) and the taxpayer became the owner of all of its capital stock (R. 34). During the period of six years between its inception and the sale in question, Innisfail engaged actively in many business transactions. It put money out on "call" (R. 55). It made investments in mining, financial, and foreign ventures (R. 52-3). It joined and subscribed $100,000 to a syndicate for the purpose of trading in Pathe stock and Government securities (R. 73-4, 229). It dealt in commodities (R. 48, 93). It sold thousands of dollars worth of securities in the open market (R. 119, 223-4, 229). It continues to this day to be a live business corporation. It has always been recognized by the Commissioner of Internal Revenue as a separate taxpaying entity (R. 172).

On December 29, 1932 the taxpayer sold and delivered a group of securities to Innisfail. Certificates for all of these securities were endorsed for transfer by the taxpayer to Innisfail (R. 20-4, 192-4). Requisite transfer stamps were attached in the amount of $1732.72 (R. 139-41, 192-4). The stock was transferred on the books of each corporation from the taxpayer to Innisfail (R. 123-9, 276-81) and new certificates were issued to Innisfail (R. 77). All the

sales were made at prevailing market prices (R. 30-2) for a total of $60,923.80 (R. 26). The securities had cost the taxpayer a total of $234,002.31 (R. 99-101), which entailed a loss of the difference.

The taxpayer maintained a running account with Innisfail (R. 78-99, 265-9, 271-5). Immediately before the sale he owed Innisfail $68,364.69 (R. 26, 265-9) principally as the result of cash dividends which he had received from certain Chrysler and Hudson stock owned by Innisfail but registered in his name as nominee in accordance with common corporate practice (R. 34-7, 63, 78-85, 124, 265-9).[1] As the purchase price of the securities sold to Innisfail was $7440.88 less than he owed Innisfail, the taxpayer gave Innisfail a check for that amount to balance the account (R. 26-7, 51-2, 98-9, 194, 265-9). The Board of Directors of Innisfail approved the acquisition of the securities by Innisfail from the taxpayer and the prices paid (R. 27).

Innisfail has received and kept all the dividends on the securities purchased from the taxpayer (R. 77, 122-3, 125-9). It was the taxpayer's unqualified intention to transfer title from himself to Innisfail and to retain no interest whatever in the securities (R. 24). It was at all times his purpose that Innisfail be an absolutely independent entity and that it stand on its own bottom (R. 41) as much as General Motors Corporation, of which the taxpayer was and is Vice President and General Counsel (R. 32). At the time Innisfail made the purchase

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[1] The Board of Tax Appeals has recently sanctioned the treatment accorded these very dividends. *John Thomas Smith*, 40 B. T. A. 387. The taxpayer received the dividends in the first instance, credited them to Innisfail on the running account and periodically brought the account into balance (R. 265-9).

from the taxpayer, it had securities valued at $791,-751.92 and cash of $17,115.03 (R. 227). The affairs of Innisfail and of the taxpayer were kept scrupulously separate. Innisfail has never reconveyed any securities purchased from the taxpayer (R. 24).

In December, 1934, the taxpayer sold all his Innisfail stock to his children (R. 29-30, 264). The running account between the taxpayer and Innisfail was, nevertheless, maintained until November, 1937, when the account was brought into final balance by a cash payment of $99,000 from the taxpayer to Innisfail.

The taxpayer and Innisfail each kept a full set of books, consisting of a cash book, journal, ledger, check book and security record (R. 75-6). These books were periodically audited by Barrow, Wade, Guthrie & Co., certified public accountants (R. 67). They verified the taxpayer's indebtedness to Innisfail and the losses on the very sales by the taxpayer to Innisfail involved in this case (R. 134-5, 144, 293-8). They found all the books and records of both the taxpayer and Innisfail to be in standard form and made no reservations in their audit reports (R. 142-3).

Upon these undisputed facts,[2] the taxpayer built his motion for a directed verdict and upon them the Court of Appeals held that it was well founded.

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[2] The Trial Judge charged the jury that "the evidence in this case is substantially undisputed, so that you are not confronted with the task of deciding what probably happened. What you will have to do is to take this evidence under careful consideration and decide what it proves" (R. 160).

Argument.

POINT I.

The taxpayer was entitled to deduct a loss on the sale to Innisfail.

1. This is a case of statutory construction. But before approaching the precise provision, we may note some parallel considerations which will ease the task of construction. As the Government admonishes, the statute must not be read with a sterile literalism that can only pervert its purposes. We, too, look to its fundamental design.

The recognition of a loss on the sale to Innisfail is not homage to empty formalism but adherence to a consistent pattern without which the law of taxation would be unintelligible. It is only one of the many consequences resulting from transactions between a corporation and its sole stockholder. Gain realized upon a sale by a corporation to its sole stockholder is taxable. *Burnet* v. *Commonwealth Improvement Co.*, 287 U. S. 415, 419. "The fact that it had only one stockholder seems of no legal significance." Assets received on the complete liquidation of a corporation constitute taxable income to the sole stockholder. *France Co.* v. *Commissioner*, 88 Fed. (2d) 917 (C. C. A. 6); *Coxe* v. *Handy*, 24 Fed. Supp. 178 (D. Del.); *John K. Greenwood*, 1 B. T. A. 291. Losses sustained by a one-man corporation may not be reported in the individual income tax return of the sole stockholder. *Dalton* v. *Bowers*, 287 U. S. 404; *Menihan* v. *Commissioner*, 79 Fed. (2d) 304 (C. C. A. 2), cert. den. 296 U. S. 651. Periods during which a sole stockholder and a corporation successively hold property may not be combined to make up the two

years required for the creation of a capital asset. *Webber v. Knox*, 97 Fed. (2d) 291 (C. C. A. 8).

The record in this very case reveals a striking illustration of the tax consequences of a wholly owned corporation. Some years ago the taxpayer purchased a block of Hudson stock for $158,000. In 1929 he sold the stock to Innisfail for $106,400. In 1932 Innisfail sold the same stock in the open market for $12,000. The taxpayer, of course, did not and could not report Innisfail's heavy loss in his 1932 income tax return (R. 119). A similar result occurred in the case of some Gimbel stock where again Innisfail's loss was not available to the taxpayer (R. 47, 296). These instances not only bring out in bold relief the statutory significance of a wholly owned corporation but also demonstrate the scrupulous fidelity with which the taxpayer respected the separate character of Innisfail.[3]

Thus it is that the entity of a wholly owned corporation has real meaning and that it does not always redound to the sole stockholder's benefit. With characteristic felicity, Mr. Justice Holmes cleared the subject of misguided generalization:[4]

> "* * * But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."

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[3] The statement on page 21 of the Government's brief that the taxpayer "ignored the corporate entity in substantially every transaction he had with it" might have been regarded by Ruskin as "pathetic fallacy".

[4] *Klein v. Board of Supervisors*, 282 U. S. 19, 24.

Against this background, the allowance of loss on a sale to a controlled corporation looms up as an integral part of the statutory scheme and we find that the courts have uniformly allowed such loss under circumstances indistinguishable from those in the case at bar. Four Courts of Appeals have held the loss deductible. *Jones* v. *Helvering*, 71 Fed. (2d) 214 (App. D. C.), cert. den. 293 U. S. 583; *Commissioner* v. *Eldridge*, 79 Fed. (2d) 629 (C. C. A. 9); *Commissioner* v. *McCreery*, 83 Fed. (2d) 817 (C. C. A. 9); *Commissioner* v. *Johnson*, 104 Fed. (2d) 140 (C. C. A. 8); *Foster* v. *Commissioner*, 96 Fed. (2d) 130 (C. C. A. 2), decided almost a year before that court decided the case at bar.[5]

The law seemed so well settled that the Solicitor General of the United States in 1935 refused to apply for certiorari in the *Eldridge* case, *supra*, even though the Treasury Department recommended it.[6] And, in *Gregory* v. *Helvering*, 293 U. S. 465, 469, the decision so heavily relied upon by the Government, this Court gave explicit endorsement to the *Jones* case, *supra*, when it declared:

> "* * * The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * *Jones* v. *Helvering*, 63 App. D. C. 204, 71 F. (2d) 214, 217."

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[5] The Board of Tax Appeals has consistently reached the same conclusion. *David Stewart*, 17 B. T. A. 604; *Corrado & Galiardi, Inc.*, 22 B. T. A. 847; *Edward Securities Corporation*, 30 B. T. A. 918; *Ralph Hochstetter*, 34 B. T. A. 791; *John Thomas Smith*, *supra*, 40 B. T. A. 387, involving prior years of the instant taxpayer.

[6] Hearings before Joint Committee on Tax Evasion and Avoidance, 1937, p. 206.

2. The Government, by invoking the doctrine of *Gregory* v. *Helvering, supra,* would deny the taxpayer the right to report the loss because of the alleged absence of "business purpose" in the sale.[7] The *Gregory* case limited the scope of the reorganization provisions to transactions having a "business purpose", *i. e.,* those involving the readjustment of a business enterprise.[8] But certainly this Court did not intend to make that the *sine qua non* for the determination of losses, especially since the *Gregory* opinion, as we have just seen, specifically approved *Jones* v. *Helvering, supra,* where there was no "business purpose". Even without so plain an expression in the *Gregory* opinion, it would have been apparent that this Court had no such intention, for the statute itself sets up the two occasions on which losses may be reported. Only one of these requires the element of business. Section 23(e) of the Act provides that there shall be allowed as deductions losses sustained during the taxable year:

"(1) if incurred in trade or business; or

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[7] In the Circuit Court of Appeals, however, the Government failed to urge this argument, specifically renounced any quarrel with the inviolability of Innisfail as a separate corporate entity and confined itself to the question of whether there was any sale at all, the argument made in Point II of its brief herein. (See footnote 11.) Under these circumstances, the Government cannot be heard to urge anything but Point II as ground for reversing the Circuit Court of Appeals. *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378; *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481.

[8] See Regulations 86, Art. 112(g)-1, adopted immediately following the *Gregory* decision. In *Electrical Securities Corp.* v. *Commissioner*, 92 Fed. (2d) 593 (C. C. A. 2), Judge L. Hand, who wrote the *Gregory* opinion in the Circuit Court of Appeals, said that the *Gregory* case restricted the reorganization provisions to corporations engaged in financial, commercial or industrial business enterprises, because the reorganization provisions were meant to allow *businesses* to be reconstructed.

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business . . .."

The Government's contention frustrates the intent of Congress by abrogating subdivision (2) and requiring every loss to be in connection with a business under subdivision (1).

The loss involved in the case at bar was incurred in a "transaction entered into for profit" under subdivision (2). The word "transaction" in subdivision (2) embraces the whole sequence of events leading up to the sale, especially the *acquisition* of the property. The expectation of profit at that time suffices for claiming the subsequent loss. *Terry* v. *United States*, 10 Fed. Supp. 183 (D. Conn.); *Hartford-Connecticut Trust Co.* v. *United States*, 10 Fed. Supp. 179 (D. Conn.); *R. W. Hale*, 32 B. T. A. 356, aff'd (without reference to this point) 85 Fed. (2d) 819 (App. D. C.); *Wadsworth R. Lewis*, 34 B. T. A. 996; *August Heckscher*, 36 B. T. A. 1181; Paul, Studies in Federal Taxation, 2d Series, page 281; *cf. Heiner* v. *Tindle*, 276 U. S. 582. Otherwise one who sold property in the open market for the purpose of establishing a tax loss would be outside the requirement that the transaction be "entered into for profit". Indeed, if the *sale* were the "transaction" that had to be "entered into for profit", all losses would be rejected and subdivision (2) would be a nullity, because any sale, at a price lower than cost, is obviously never "entered into for profit".

3. We have shown that it is sufficient that the loss be sustained in a transaction entered into for profit and we have shown that the requirement of "business purpose" established by the *Gregory* case is inapplicable to the case at bar. But even if there

were some requirement that the sale must be charged with "business purpose", we would be prepared to show that this sale was so charged.

Just prior to the sale the taxpayer owed Innisfail approximately $67,000. One of the purposes of the transaction was to eliminate this indebtedness (R. 63). The market value of the securities sold by the taxpayer to Innisfail was about $60,000 and the taxpayer gave Innisfail a check for the remaining $7,000 to balance the account. It had for many years been the business practice of the taxpayer to bring his account with Innisfail into balance at periodic intervals and that practice continued long after any possible tax motives could be attributed to him. Again, the very payment of the $7,000 cash amount shows the business reality of the transaction for if the taxpayer had been engaged in a subterfuge he could have transferred securities for as much or more than the amount of the indebtedness. In the same year the taxpayer sold approximately one-half million dollars worth of Chrysler stock in the open market, sustaining about a quarter of a million dollar loss (R. 415). If Innisfail were a mere sham, the taxpayer would, as he could, have sold this stock to Innisfail. But he did not do that. He sold Innisfail only what Innisfail was in a financial position to handle. Innisfail bought only so much as there was business reason for it to buy in receiving payment on the taxpayer's debt to it.

The Government's brief states on page 19 that "The Revenue Act contemplates genuine losses, recognized as such by the bu iness world * * *". What could better satisfy this test than the recognition of the losses by the certified public accounting firm of Barrow, Wade & Guthrie (R. 135, 293)?

Innisfail itself had a live and legitimate business purpose. One of the two reasons why the taxpayer organized Innisfail was because he "wanted a business corporation" (R. 35). During the period of six years between its inception and the date of the transaction in question, Innisfail engaged actively in many business transactions. It put money out on "call" (R. 55). It made investments in mining, financial and foreign ventures (R. 52-3). It joined and subscribed $100,000 to a syndicate for the purpose of trading in Pathe stock and Government securities (R. 73-4, 229). It dealt in commodities (R. 48-93). It sold thousands of dollars worth of securities in the open market (R. 119, 223-4, 229). It continues to this day to be an active business corporation. Whatever "business purpose" may mean it can hardly exclude the foregoing activities, the very stuff of which business is made.

4. We have seen that the requirement of "business purpose" may not be imported from the *Gregory* case to the statutory loss provision and that in any event it would be satisfied by the facts of the case at bar. We have also seen that the sale by the taxpayer to Innisfail was "a transaction entered into for profit" within the meaning of the loss provision. Only one Government contention remains—that, because of the relationship of seller and buyer, the sale was not a "closed", "identifiable" event. This contention is disposed of by *Burnet* v. *Commonwealth Improvement Co., supra*, 287 U. S. 415, a definitive authority for the taxpayer not only on the issue of "closed transaction" but of "business purpose" as well. In that case, the trustees of the Widener Estate owned all the stock of a corporation and "completely

dominated" it. Widener had formed the corporation during his lifetime to avoid multifold inheritance taxes. It was regarded as an "informal" corporation. The clerks and bookkeepers of the estate and the office expenses of the estate were paid by the corporation. A running account was maintained between the corporation and the trustees. Transfers were effected from the corporation to the trustees as well as vice versa and were recorded by book entries. In 1920 the corporation sold securities to the trustees in consideration for the cancellation of an indebtedness which it owed the trustees. This Court held the sale to be a taxable transaction.

The case bears an astonishing resemblance to the case at bar. The motive actuating the creation of the corporation was the same as a motive in the case at bar. The corporation was described by its owners as "informal", the same as in the case at bar.[9] The consideration for the sale was cancellation of an indebtedness, the same as in the case at bar. All relevant elements—background, stockholder-corporation relationship, sale, transfer, consideration, intent—were identical. The role of "business purpose" was the same as in the case at bar, for the securities were transferred from corporation to stockholder in consideration for the cancellation of an indebtedness. Can the difference be that the sale in the case at bar was to take a loss and, therefore, lacked "business purpose" while the sale in the *Burnet* case was to realize a gain and, therefore, had a "business purpose"? The answer is "No", for the sale in the *Burnet* case was also to take a loss. What happened was that the corporation reported a loss, the Commissioner,

[9] The Government attaches great importance to the fact that the taxpayer regarded Innisfail as an "informal" corporation and refers to this fact no less than three times in its brief.

upon audit, found the cost to be lower than reported in the return and the loss turned into a gain. But the intent at the time of the sale was the same as the intent in the case at bar; both taxpayers sold with the expectation of loss.

The way is now clear to see the impact of the *Burnet* case on the Government's contention that the sale to Innisfail was not such a "final" disposition as to entitle the taxpayer to a loss. The Government says a deductible loss must be realized "by some closed event * * * and a sale may constitute such closed event only when there is a final disposition of the property in question". The *Burnet* case is a controlling authority to the effect that the sale to Innisfail meets this test. The *Burnet* case involved a sale resulting in gain, but surely a redetermination of cost after the sale cannot alter the complexion of the sale. The sale, when made, is either a "closed", "identifiable" event or it is not. If it is, realization of loss as well as gain flows from it. If it is not, realization of neither gain nor loss results. A decision that the transaction was the kind of a transaction upon which gain is to be predicated necessarily compels a decision that it was the kind of a transaction upon which loss must be predicated. Indeed the requirement for a "closed", "identifiable" event may well be stricter in the case of gain than in the case of loss, because a constitutional question lurks in the case of gain. *Eisner* v. *Macomber*, 252 U. S. 189; *Weiss* v. *Stearn*, 265 U. S. 242.

The Government challenges the finality of the sale because the taxpayer as sole stockholder of Innisfail had the power to effect a reconveyance of the securities. The same objection would, of course, apply to a case of gain and is disposed of by the *Burnet* case. But there is another answer to the Government's con-

tention. *The taxpayer could have retaken the securities from Innisfail only in a taxable transaction,* for the reconveyance could be only by way of a dividend or upon liquidation of Innisfail. In either case, a sizeable tax would have been incurred.[10] Far from prejudicing the public revenue by any such maneuver, the taxpayer would have incurred substantial additional tax thereby. And, of course, it is wholly unrealistic to try to make capital out of the taxpayer's power to repurchase the securities from Innisfail; if such power were the test, no sale of listed securities would ever be final for there is always power to repurchase such securities.

The Government seeks to explain the *Burnet* case by recourse to the dogma that the corporate entity will never be disregarded in favor of the corporation. But the dogma itself is false. This Court has disregarded the corporate fiction in favor of a corporation. *Southern Pacific* v. *Lowe,* 247 U. S. 330; *Gulf Oil* v. *Lewellyn,* 248 U. S. 371. These two cases were considered by this Court in the *Burnet* case but this Court said that the sale in the *Burnet* case gave rise to taxable gain because of "the actual transfer of securities and the payment of a debt", while the *Southern Pacific* and *Gulf Oil* cases involved "mere bookkeeping or paper transactions". The question thus turns on the reality of the sale not the personality of the party who seeks to have the corporate entity disregarded. As the sale in the case at bar involved facts identical with the sale in the *Burnet* case, the same result must follow.

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[10] The Innisfail stock in the hands of the taxpayer had a very low cost basis as shown by the difference between that cost and the market value of the stock when the taxpayer disposed of it to his children in 1934 and paid a substantial gift tax upon the transaction (R. 29-30, 264).

Moreover, whatever else may be open for the Government to argue, it may not urge this Court to disregard the corporate entity, because in the plainest words the Government in the court below conceded that the corporate entity could not be disregarded in the case at bar.[11] Nor did the Government's petition for certiorari ask this Court to disregard the corporate entity. Yet the Government attempts to distinguish the *Burnet* case on the ground that the corporate entity will not be disregarded in favor of the corporation, thus implying that it should be disregarded in the case at bar.

5. This is, to repeat, a case of statutory construction. The legislative history of all the Revenue Acts and an analysis of the provisions of the Revenue Act of 1932 compel the conclusion that the taxpayer was entitled to a deduction for the loss on the sale to Innisfail. We could have opened and closed on this single note. However, in view of the Government's polemics, it seemed desirable to clear the atmosphere for a dispassionate appraisal of the statutory provisions. Section 24(a) (6) of the Revenue Act of

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[11] The Government's brief in the Circuit Court of Appeals stated:

"*Jones* v. *Helvering*, 71 F. (2d) 214, *Commissioner* v. *Eldridge* 79 F. (2d) 629, *Commissioner* v. *McCreery*, 83 F. (2d) 817 and *Foster* v. *Commissioner* 96 F. (2d) 130 are cited in plaintiff's brief in support of his contention that losses resulting from sales by a taxpayer to wholly owned or controlled corporations are deductible because of the inviolability of the corporation as a separate entity.

"Neither the Court below nor the Government is in disagreement with that contention. That represents a principle of law which may be applied to a situation where, as a matter of fact *there was a "sale*". (Italics Government's.)

1934, c. 277, 48 Stat. 680, was enacted for the very purpose of precluding losses on sales to closely related persons.[12] In view of the occasional difficulty of sifting real from sham sales in such instances, Congress wisely eliminated these deductions altogether. The enactment of this amendment is convincing proof that theretofore such losses were allowable and that the sole test was whether the loss was real rather than feigned. *Foster v. Commissioner, supra,* 96 Fed. (2d) 130. The committee reports in both the Senate and House show that the statute was passed for the express purpose of abolishing these losses, which Congress believed allowable under preexisting law.[13] And the proceedings of the Joint Committee on Tax Evasion and Avoidance in June, 1937, demonstrate a clear understanding by members of Congress and ex-

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[12] See Appendix, page 34, for full text of section.

[13] The Report of the Committee on Ways and Means of the House of Representatives states at page 23, referring to Section 24(a) (6):

> "The bill adds to existing law a paragraph which will deny losses to be taken in the case of sales or exchanges of property between members of a family, or between a shareholder and a corporation in which such shareholder holds a majority of the voting stock. * * *
>
> Experience shows that the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax. *It is believed that the proposed change will operate to close this loophole of tax avoidance.*" (House Rep. No. 704, 73d Congress, 2d Session. Italics supplied.)

The Reports of the Finance Committee of the Senate and of the subcommittee of the House Ways and Means Committee are to the same effect. (Senate Report No. 558, 73d Congress, 2d Session, p. 27; Hearings before Committee on Ways and Means, Revenue Revision 1934, p. 134.) See also remarks of Senator Harrison, Chairman of Senate Finance Committee, 78 Congressional Record, page 5847. *Cf.* Report on Stock Exchange Practices, Senate Committee on Banking and Currency. (Senate Report No. 1455, 73d Congress, 2d Session, pp. 321-327.)

perts of the Treasury Department that the effect of the statute on this precise situation was to deny a loss that was, until 1934, indisputable.[14]

If there were any doubt that as a matter of statutory construction a loss such as that involved in this case was allowable prior to the 1934 amendment, that doubt would be resolved by Sec. 112(b) (5) of the Revenue Act of 1932 dealing with "transfer to corporation controlled by transferor".[15] This section provided that no gain or loss should be recognized if property were transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange the transferor were in control of the corporation. If the Government were right in its contention that there is no realization of loss in a transfer by a sole stockholder to his wholly owned corporation, there would have been no need for this provision precluding loss where a taxpayer transferred property to a corporation in ex-

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[14] Hearings before Joint Committee on Tax Evasion and Avoidance, 1937, page 207 (referring to *Commissioner* v. *Eldridge*, 79 F. (2d) 629, *supra*, p. 9):

"*Mr. Kent*: . . . I should have stated, as I intended to do, that so far as the particular situation presented in this recent case is concerned, it had been taken care of by the Congress in the amendment contained in Section 24-A (6), Revenue Acts of 1934 and 1936, which denied to an individual a deduction for losses on shares sold or exchanged by him with a corporation in which he holds directly or indirectly the controlling interest.

"*Mr. Cooper*: . . . While this decision arose under prior acts, it could not arise under existing law.

"*Mr. Vinson*: Of course, that decision was on the old statute?

"*Mr. Kent*: That is true, that was under the law as it existed prior to 1934."

[15] See Appendix, page 31.

change for all the capital stock of the corporation.[16] The very presence of Section 112(b) (5) in the Revenue Act of 1932 is, therefore, additional proof that Congress permitted losses on sales to controlled corporations until Congress proclaimed in 1934 that it would no longer permit such losses. The Government's contention is in effect an attempt to extend Section 112(b) (5) to the facts of the case at bar, a situation which it can under no reasonable construction be made to cover.

The law is now clear that, for the period since 1934, deductions are not allowed for losses incurred on sales to controlled corporations. It is equally clear that such deductions were uniformly allowed for the period prior to 1934. There is no occasion at this late date to upset the established law for a period ended six years ago. And it would be unfortunate if this Court should reverse itself in what is probably the last case to be presented here on this question.

POINT II.

The taxpayer was entitled to a directed verdict.

We now address ourselves to the Government's somewhat half-hearted argument, though its only argument below, that the verdict must stand because there was a question of fact for the jury as to whether there was a sale at all. This is Point II of the Government's brief. We shall show that the Circuit Court of Appeals was right in holding that the Trial

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[16] In its argument before the Circuit Court of Appeals in *Commissioner* v. *Johnson*, No. 317, this term, to be heard immediately after the case at bar, the Government sought to invoke Section 112(b) (5) as a bar to the taxpayer's loss. The argument was rejected because it had not been urged in the Board of Tax Appeals.

Court had erred in denying the taxpayer's motion for a directed verdict.

The facts were undisputed. Indeed, as we have seen, the trial judge charged the jury that "the evidence in this case is substantially undisputed, so that you are not confronted with the task of deciding what probably happened. What you will have to do is to take this evidence under careful consideration and decide what it proves" (R. 160). The Circuit Court of Appeals concluded (R. 339-40): "Thus it was proved that the securities here involved were actually sold to Innisfail and the legal title to them has ever since been in the purchaser . . . As the evidence was undisputed and proved an actual sale of these securities which permanently divested the plaintiff of title to them, his motion for a directed verdict on this cause of action should have been granted." The only issue was one of law as to whether the facts entitled the taxpayer to a deductible loss and, on this issue, our argument in Point I shows that there could be but one proper answer. Even if there were a mixed question of law and fact, the ultimate decision would be for the court. *Helvering* v. *Tex-Penn Oil Co.,* 300 U. S. 481, 491; *Helvering* v. *Rankin,* 295 U. S. 123, 131; *Bogardus* v. *Commissioner,* 302 U. S. 34, 39.

In *Jones* v. *Helvering, supra,* 71 Fed. (2d) 214, 216, cert. den. 293 U. S. 583, the court reversed the Board, which had denied a loss on the sale to a controlled corporation. The court said:

> "* * * when * * * the evidence is uncontradicted and unimpeached, we think we are bound, without regard to the Board's finding, to give it effect."

Conversely, in *Commissioner* v. *Dyer*, 74 Fed. (2d) 685 (C. C. A. 2), cert. den. 296 U. S. 586, involving a similar situation, the Board held for the taxpayer and the Court of Appeals reversed, holding that as a matter of law the taxpayer had not sustained a loss.[17] In *Griffiths* v. *Commissioner*, No. 49, and *Commissioner* v. *Johnson*, No. 317, to be heard, respectively, immediately before and immediately after the instant case, the Board upheld sales to controlled corporations and the Government now asks this Court to upset the Board's conclusions because a question of law alone is involved. The Government's attempt to rely on the finality of the jury verdict in the case at bar is, of course, irreconcilable with its attack on the Board's decisions in the *Griffiths* and *Johnson* cases. Surely the general verdict of a jury is entitled ~~to~~ no more weight than the considered conclusion of an expert quasi-judicial body.

Denial of the taxpayer's motion for a directed verdict cannot be justified on the ground that some of the evidence came from interested witnesses. *Chesapeake & Ohio Railway Co.* v. *Martin*, 283 U. S. 209; *Hull* v. *Littauer*, 162 N. Y. 569, 572. In the former case, this Court set out the following statement ~~as the~~ correct rule:

[17] Courts of Appeals are constantly reversing judgments involving the deductibility of losses on sales. *Budd* v. *Commissioner*, 43 Fed. (2d) 509 (C. C. A. 3); *American Auto Trimming Co.* v. *Lucas*, 37 Fed. (2d) 801 (App. D. C.); *Marston* v. *Commissioner*, 75 Fed. (2d) 936 (C. C. A. 2); *Marston* v. *Commissioner*, 75 Fed. (2d) 938 (C. C. A. 2); *Commissioner* v. *Riggs*, 78 Fed. (2d) 1004 (C. C. A. 3), cert. den. 296 U. S. 637; *Commissioner* v. *Troup*, 75 Fed. (2d) 1010 (C. C. A. 7), cert. den. 296 U. S. 586; *Rasmusson* v. *Eddy's Steam Bakery, Inc.*, 57 Fed. (2d) 27 (C. C. A. 9); *St. Louis Union Trust Co.* v. *United States*, 82 Fed. (2d) 61 (C. C. A. 8); *Madeira* v. *Commissioner*, 98 Fed. (2d) 556 (C. C. A. 3).

"* * * It is not proper to submit uncontradicted testimony to a jury for the sole purpose of giving the jury an opportunity to nullify it by discrediting the witness, when nothing more than mere interest in the case exists upon which to discredit such witness."

Moreover, the testimony of the taxpayer, who was the only *interested* witness, was amply corroborated at every vital point by the other witnesses and by the documentary evidence. The intent to transfer title was supported by written assignments of the stock certificates and by the transfer records of the corporations whose stocks were sold. The payment of full consideration was attested by checks, bank records and a complete set of books kept by the taxpayer and Innisfail in the ordinary course of business. Documented proof corroborated every oral assertion. The Government called only one witness, whose testimony was unrelated to any issue now before this Court and is nowhere referred to in the Government's brief.

POINT III.

If not entitled to a directed verdict, the taxpayer would be entitled to a new trial because of errors by the trial court.

We have argued that the taxpayer was entitled to a directed verdict and that the Circuit Court of Appeals was right in reversing the judgment because the case should never have been submitted to the jury. We have shown that the evidence was undisputed and that on the facts, as established, the taxpayer was entitled to recover as a matter of law. But even if the taxpayer were not entitled to a directed verdict and even if the case should have been submitted to

the jury, the verdict could not stand; a new trial would be necessary because of errors in the charge and in the admission of evidence. Many such errors were pointed out and pressed by the taxpayer in the Circuit Court of Appeals, but we shall here present only two because we believe each of them alone to be decisive.[18]

1. The trial judge instructed the jury that book entries are not evidence of the transactions which they record.[19] This instruction is in direct contravention of the Act of June 20, 1936, c. 640, §1, 49 Stat. 1561, which provides that:

> "* * * any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence, or event, *shall be admissible as evidence of said act, transaction, occurrence, or event,* if it shall appear that it was made in the regular course of any business and that it was the regular

[18] The respondent may always defend a judgment on any ground consistent with the record, even if rejected in the lower court. *Interstate Commerce Commission* v. *Illinois Central R. R.*, 215 U. S. 452, *Frey & Son, Inc.* v. *Cudahy Packing Co.*, 256 U. S. 208; *United States* v. *American Railway Express Co.*, 265 U. S. 425; *Helvering* v. *Gowran*, 302 U. S. 238, 51 Harvard Law Rev. 1058, 1059-60. The grounds urged by the taxpayer for a new trial were not rejected by the Circuit Court of Appeals but found unnecessary to the disposition of the case.

[19] "The Court: I think the jury understand. It is not evidence of the transactions; it is evidence that the plaintiff kept a record and this is the record. The fact that he kept a record is not proof in and of itself that he did certain things. He might have kept a record in which he discovered the North Pole, but that would not prove that he did it.

"Mr. Sher: If your Honor please, I most respectfully except to that part of it. I think that books of account are certainly some evidence of the transactions which they describe.

course of such business to make such memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter * * *."[20] (Italics supplied.)

Even before the adoption of the above statute it was clear that records like those here involved constitute evidence. *Wessel* v. *United States*, 49 Fed. (2d) 137 (C. C. A. 8).

The consideration given by Innisfail for the stock which it bought from the taxpayer was extinguishment of an indebtedness due it from the taxpayer. It was, therefore, necessary to prove the existence of this indebtedness in order to prove the consideration for the sale. Such proof was adduced by introducing the books and records of both Innisfail and the taxpayer, as well as supporting documents such as checks, bills, and memoranda of sale (R. 79-99, 265, 271-6). The sweeping direction given the jury that it need not consider the books as *any* evidence of the transactions was a flagrant error resulting in grave prejudice to the taxpayer.

2. The trial court admitted a large mass of remote and prejudicial evidence over the vigorous objection

"The Court: This is not strictly a book of account. I guess you understand that.

"Mr. Sher: It is a transcript from the ledger, your Honor, and as long as there is no objection to its authenticity, then it is the ledger which we are offering, and that certainly is evidence of a transaction.

"The Court: You just except to any instructions to the jury that you do not approve of and that will preserve your client's rights, and we will pass on."

Although the trial judge said that he was admitting the entries as "a competent part of the plaintiff's proof", it is nevertheless clear from the above colloquy that he was admitting them only as "evidence that the plaintiff kept a record" and not evidence at all that the plaintiff "did certain things" (R. 69-70).

[20] See Appendix, pages 34-5, for full text of statute.

of the taxpayer. Although the action concerned only the tax year 1932, the trial court permitted the Government to show that the taxpayer reported large capital losses in 1929 and in 1931 (R. 63-4, 110-13). The Government was also permitted to show that the taxpayer conveyed a block of Chrysler preferred stock to Innisfail in 1926, that Innisfail subsequently exchanged this stock for Chrysler common stock and that the taxpayer would have paid a much larger tax than Innisfail paid if he himself had made the exchange (R. 103-7). During the years 1926 to 1932 a considerable amount of stock owned by Innisfail was registered in the name of the taxpayer as nominee. The taxpayer received the dividends on this stock and credited them to Innisfail on the running account maintained between the two (R. 265-9). The running account was regularly brought into balance so that the taxpayer paid over the dividends to Innisfail. The Government was allowed to ask the taxpayer's secretary on cross-examination how much more income tax, year by year, the taxpayer would have had to pay on these dividends if he had received them on his own account instead of for the account of Innisfail (R. 107-14).

It is abundantly clear that the purpose behind the introduction of this evidence was to convey to the jury the impression that over a period of many years prior to the year in question the taxpayer had assiduously pursued a course of tax minimization. The district attorney revealed his purpose with commendable candor when he said: "We are attempting (to show) he had the thought at all times in mind as to the reduction of his income tax liability" (R. 71). This clearly prejudicial evidence had no legitimate bearing on the case. Authority hardly need be cited

for the proposition that a taxpayer's purpose to minimize taxes is unexceptionable. The evidence was not therefore calculated to show any relevant intent or design.[21]

The obvious purpose of the evidence about these earlier events was to inflame the minds of the jurors against the taxpayer, to brand him with the stigma of tax avoidance, and to deny him an impartial consideration of his case by the jury. That it achieved its purpose only too well is demonstrated by the verdict against the taxpayer on the sale to Innisfail.

POINT IV.

If this Court holds that the taxpayer was entitled to a directed verdict, this Court should order the entry of judgment rather than a new trial.

If this Court holds that the taxpayer was entitled to a directed verdict, then this Court should not merely affirm the decision of the Circuit Court of Appeals but should direct the District Court to enter judgment in favor of the taxpayer. The Circuit Court of Appeals itself first made this disposition but, upon the Government's motion for rehearing, withdrew its order for the direction of judgment and substituted an order for a new trial. The taxpayer filed a cross-petition for certiorari from this phase of the Circuit Court of

[21] Nor was the testimony admissible on any theory of "similar" transactions, for the testimony was not similar to any transaction at issue in the trial. There was no contention that in 1932 the taxpayer should have returned as income any dividends paid on stock held by Innisfail. The only question was whether he was entitled to a loss on the sale to Innisfail. It is well settled that other transactions cannot be shown unless they are "identical". *Johnstown Tribune Publishing Co.* v. *Briggs*, 76 Fed. (2d) 601 (C. C. A. 3); *Newman* v. *United States*, 289 Fed. 712 (C. C. A. 4); *People* v. *Harvey*, 235 N. Y. 282.

Appeals decision. The cross-petition was denied but we assume that it was denied because it was unnecessary, *Gompers* v. *United States*, 233 U. S. 604, 607, since this Court upon deciding the case presented by the Government's petition must mould the judgment to be entered below.[22]

The only impediment to an order directing the entry of judgment is the case of *Slocum* v. *N. Y. Life Insurance Co.*, 228 U. S. 364, holding that the Seventh Amendment requires a new trial. But the instant action was brought against a Collector of Internal Revenue for the refund of taxes, and such an action, although nominally against the Collector, is "to all intents and purposes . . . an action against the Government for monies in the 'treasury'". *Auffmordt* v. *Hedden*, 137 U. S. 310, 329; *Moore Ice Cream Co.* v. *Rose*, 289 U. S. 373, 382-3. The Seventh Amendment does not apply to such suits. *Wickwire* v. *Reinecke*, 275 U. S. 101, 104-5; *Murray's Lessee, et al.* v *Hobo-*

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[22] Although the general rule is that the respondent may not challenge the judgment below, there is a well established exception where the respondent's attack involves matter closely related to the subject of the appellant's attack. *United Railways & Electric Co.* v. *West*, 280 U. S. 234, 253; *Lucas* v. *Alexander*, 279 U. S. 573, 576; see also *Gompers* v. *United States*, 233 U. S. 604, *supra*. The case at bar is comfortably within the exception, because the order for a new trial made by the appellate court is regarded as "a part of its judgment of reversal". It is this judgment which is here for review on certiorari. *Haseltine* v. *Central Bank of Springfield*, 183 U. S. 130, 131; *Smith* v. *Adams*, 130 U. S. 167, 177.

Moreover the general rule has been severely criticized as an obstacle to complete justice. See an interesting note in 51 Harvard Law Rev. 1058, *supra*.

Of course, if this Court affirms because of our argument in Point II that there were errors at the trial in the admission of evidence and instructions to the jury, then the case must be sent back for a new trial.

ken Land & Improvement Co., 18 How. 272; *Edwin Cigar Co.* v. *Higgins*, 17 Fed. Supp. 988, 991. The Bill of Rights was intended only to afford protection *against* the federal government. The *Slocum* rule is incongruous with the case at bar.

Moreover, this Court should overrule the *Slocum* case and establish the doctrine that an appellate court, upon reversing the trial court for error in denying a motion for a directed verdict, should order the entry of judgment. When the decision in the *Slocum* case was announced about twenty-five years ago, lawyers and scholars alike were dismayed. Four Justices joined in an exhaustive dissenting opinion denying the constitutional necessity for the decision and deploring the unfortunate practical consequences with which it was pregnant. Confirmation of the warning sounded by the dissent was not slow to follow. The multiplication of new trials, born of the *Slocum* case, was immediately decried as "one of the greatest abuses in the administration of justice".[23] More recently, an outstanding authority on federal procedure laconically characterized its effect as "this waste".[24] An even graver objection had been pointed out by Ezra Ripley Thayer. "The result", he lamented, "is worse than waste because of the sharp temptation which the new trial offers the prevailing party to make his evidence meet the demands of the law as now laid down."[25]

Lack of adequate judicial statistics prevents an

[23] Petition for rehearing in *Slocum* case filed by Everett P. Wheeler in behalf of the American Bar Association and subscribed by Roscoe Pound, Joseph H. Choate and others.

[24] Charles E. Clark, A New Federal Civil Procedure, I. The Background, 44 Yale Law Journal, 387, 408.

[25] Thayer, Judicial Administration, 63 U. of Pa. L. R. 585, 600.

exact toll of the damage wrought.[26] It was so serious however, that remedy by constitutional amendment was suggested as a pressing necessity.[27]

An ingenious attempt to avoid the unfortunate results of the *Slocum* decision has been made in Rule 50(b) of the new Federal Rules of Civil Procedure, but the path is tortuous and the ground tenuous. Until the *Slocum* case is formally repudiated by this Court, certain plausible attacks on the Rule must be expected.[28] It would therefore be healthy to remove the anachronistic *Slocum* doctrine altogether, for so long as it stands, courts may, as the court below did, fall under the influence of its illusory authority.

The new rules testify to the desirability of entering judgment under the circumstances of the case at bar. Why should not this Court say so, instead of professing adherence to the *Slocum* case while countenancing a tunnel under it?

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[26] Its wide potential application is indicated, however, by the facts (1) that in the year ending June 30, 1938, there were reversals in 31.2% of the cases heard and decided by the Circuit Courts of Appeals and the Court of Appeals of the District of Columbia, 1938 Annual Report of the U. S. Attorney General, pages 216-217; (2) that in the year covered by the American Law Institute's Study of the Federal Courts, a new trial was granted in 18.5% of all cases prior to final disposition. Study of the Business of the Federal Courts (1934), page 98.

[27] Superfluous New Trials and the Seventh Amendment, Editorial, 26 Green Bag 106-7.

[28] Ohlinger, Federal Practice (1938), Vol. 3, page 635.

CONCLUSION.

The decision of the Court below should be affirmed and the case remanded to the District Court with a direction to enter judgment for the taxpayer.

Respectfully submitted,

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New York, New York, November 13, 1939.

APPENDIX.

Revenue Act of 1932, c. 209, 47 Stat. 169:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(e) *Losses by individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

Sec 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) * * *

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in

such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Revenue Act of 1934, c. 277, 48 Stat. 680:

Sec. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants.

Act of June 20, 1936, c. 640, §1, 49 Stat. 1561:

In any court of the United States and in any court established by Act of Congress, any writing or record, whether in the form of an entry in a book or

otherwise, made as a memorandum or record of any act, transaction, occurrence, or event, shall be admissible as evidence of said act, transaction, occurrence, or event, if it shall appear that it was made in the regular course of any business, and that it was the regular course of such business to make such memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter. All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but they shall not affect its admissibility. The term "business" shall include business, profession, occupation, and calling of every kind.

SUPREME COURT OF THE UNITED STATES.

No. 146.—October Term, 1939.

Joseph T. Higgins, Collector of Internal Revenue for the Third District of New York, Petitioner, *vs.* John Thomas Smith.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[January 8, 1940.]

Mr. Justice Reed delivered the opinion of the Court.

Certiorari was allowed[1] from the judgment of the Circuit Court of Appeals for the Second Circuit[2] on account of an asserted conflict between the decision below and that of the Circuit Court of Appeals for the Seventh Circuit in *Commissioner* v. *Griffiths*.[3] The issue considered here is whether a taxpayer under the circumstances of this case is entitled to deduct a loss arising from the sale of securities to a corporation wholly owned by the taxpayer. The statute involved is Section 23(e) of the Revenue Act of 1932.[4]

The Innisfail Corporation was wholly owned by the taxpayer, Mr. Smith. It was organized in 1926 under the laws of New Jersey. The officers and directors of the corporation were subordinates of the taxpayer. Its transactions were carried on under his direction and were restricted largely to operations in buying securities from or selling them to the taxpayer. While its ac-

[1] 308 U. S. —.

[2] 102 F. (2d) 456.

[3] 103 F. (2d) 110, affirmed *sub nom.* Griffiths *v.* Commissioner, 308 U. S. —, No. 49, October Term 1939, decided December 18, 1939.

[4] 47 Stat. 169, 179-80. "Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(e) Losses by Individuals.—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; . . ."

counts were kept completely separate from those of the taxpayer, there is no doubt that Innisfail was his corporate self. As dealings by a corporation offered opportunities for income and estate tax savings, Innisfail was created to gain these advantages for its stockholder. One of its first acts was to take over an option belonging to the taxpayer for the acquisition by exchange of a block of Chrysler common stock. Through mutual transactions in buying and selling securities, and receiving dividends, the balance of accounts between Innisfail and the taxpayer resulted, on December 29, 1932, in an indebtedness from him to Innisfail of nearly $70,000. On that date, as a partial payment on this indebtedness, a number of shares of stock were sold to the corporation by the taxpayer at market. The securities sold had cost the taxpayer more than the price charged to the corporation, and in carrying out the transaction the taxpayer had in mind the tax consequences to himself.

In computing his net taxable income for 1932, the taxpayer deducted as a loss the difference between the cost of these securities and their sale price to his wholly owned corporation. The Commissioner of Internal Revenue ruled against the claim, whereupon respondent paid the tax and brought this suit for refund in the United States District Court for the Southern District of New York. The case was tried before a jury and the verdict was adverse to the taxpayer's claim that the purported sales of these securities to Innisfail marked the realization of loss on their purchase. On appeal the judgment was reversed and the case remanded to the District Court for a new trial. It was the opinion of the Court of Appeals that the facts as detailed above, as a matter of law, established the transfer of the securities to Innisfail as an event determining loss.

Under Section 23(e) deductions are permitted for losses "sustained during the taxable year." The loss is sustained when realized by a completed transaction determining its amount.[5] In this case the jury was instructed to find whether these sales by the taxpayer to Innisfail were actual transfers of property "out of Mr. Smith and into something that existed separate and apart from him" or whether they were to be regarded as simply "a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and fact there

[5] Burnett v. Huff, 288 U. S. 156, 161.

was no transfer at all." The jury agreed the latter situation existed. There was sufficient evidence of the taxpayer's continued domination and control of the securities, through stock ownership in the Innisfail Corporation, to support this verdict, even though ownership in the securities had passed to the corporation in which the taxpayer was the sole stockholder. Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.

It is clear an actual corporation existed. Numerous transactions were carried on by it over a period of years. It paid taxes, state and national, franchise and income. But the existence of an actual corporation is only one incident necessary to complete an actual sale to it under the revenue act. Title, we shall assume, passed to Innisfail but the taxpayer retained the control. Through the corporate forms he might manipulate as he chose the exercise of shareholder's rights in the various corporations, issuers of the securities, and command the disposition of the securities themselves. There is not enough of substance in such a sale finally to determine a loss.

The Government urges that the principle underlying *Gregory* v. *Helvering*[6] finds expression in the rule calling for a realistic approach to tax situations. As so broad and unchallenged a principle furnishes only a general direction, it is of little value in the solution of tax problems. If, on the other hand, the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration. There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire taxpaying group.[7]

The taxpayer cites *Burnet* v. *Commonwealth Improvement Company*[8] as a precedent for treating the taxpayer and his solely

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[6] 293 U. S. 465.

[7] Cf. Stone v. White, 301 U. S. 532, 537.

[8] 287 U. S. 415.

owned corporation as separate entities. In that case the corporation sold stock to the sole stockholder, the Estate of P. A. B. Widener. The transaction showed a book profit and the corporation sought a ruling that a sale to its sole stockholder could not result in a taxable profit. This Court concluded otherwise and held the identity of corporation and taxpayer distinct for purposes of taxation.[9] In the *Commonwealth Improvement Company* case, the taxpayer, for reasons satisfactory to itself voluntarily had chosen to employ the corporation in its operations. A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.[10]

On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.[11]

Such a conclusion, urges the respondent, is inconsistent with the prior interpretations of the income tax laws and consequently unfair to him. He points to the decisions of four courts of appeals which have held losses determined by sales to controlled corporations allowable[12] and further calls attention to the fact that the

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9 See also Klein v. Board of Supervisors, 282 U. S. 19; Dalton v. Bowers, 287 U. S. 404; Burnet v. Clark, 287 U. S. 410.

10 Cf. Edwards v. Chile Copper Co., 270 U. S. 452, 456.

11 Lucas v. Earl, 281 U. S. 111; Corliss v. Bowers, 281 U. S. 376; Griffiths v. Commissioner, 308 U. S. —, No. 49, October Term 1939, decided December 18, 1939.

12 Jones v. Helvering, 71 F. (2d) 214 (April 23, 1934, reversing 18 B. T. A. 1225, decided February 18, 1930), cert. denied October 8, 1934, 293 U. S. 583; Commissioner v. Eldridge, 79 F. (2d) 629 (November 4, 1935, affirming 30 B. T. A. 1322, decided July 31, 1934); Commissioner v. McCreery, 83 F. (2d) 817 (May 13, 1936, affirming B. T. A. memorandum opinion of June 19, 1935); Foster v. Commissioner, 96 F. (2d) 130 (April 18, 1938, affirming B. T. A. memorandum opinion of December 23, 1935); Commissioner v. Johnzon, 104 F. (2d) 140 (June 1, 1939, affirming 37 B. T. A. 155, decided January 21, 1938), affirmed by an equally divided Court, 308 U. S. —, No. 317, October Term 1939, decided December 11, 1939.

Board of Tax Appeals has consistently reached the same conclusion.[13] But this judicial and administrative construction has no significance for the respondent. The Bureau of Internal Revenue has insistently urged since February 18, 1930, the date of the Board of Tax Appeals' decision in *Jones* v. *Helvering*,[14] that a transfer from a taxpayer to a controlled corporation was ineffective to close a transaction for the determination of loss. Every case cited by respondent in the courts of appeals and before the Board of Tax Appeals found the Government supporting that contention. The Board's ruling in the *Jones* case was standing unreversed at the time of the transaction here involved, December 29, 1932. It was only after the transactions here involved and after the reversal of the Board in the *Jones* case on April 23, 1934, or this Court's refusal of certiorari on October 8, 1934, that the Board of Tax Appeals and the courts of appeals, over Government protests, ruled in line with the opinion of the Court of Appeals of the District of Columbia in the *Jones* case. If the Bureau's stand in the *Jones* case represented a change in administrative practice, there can be no doubt that the change operated validly at least from 1930 on.[15] After the *Jones* defeat the Government sought relief in Congress and after the judgment in *Commissioner* v. *Griffiths, supra*, certiorari here on a conflict in principle between circuits. Certainly there was no acquiescence by the Government which would justify the taxpayer in relying upon prior interpretations of the law.[16]

Respondent makes the further point that the passage of Section 24(a)(6) of the Revenue Act of 1934[17] which explicitly forbids any

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13 David Stewart *v.* Commissioner, 17 B. T. A. 604; Corrado & Galiardi, Inc. *v.* Commissioner, 22 B. T. A. 847; Edward Securities Corporation *v.* Commissioner, 30 B. T. A. 918; Ralph Hochstetter *v.* Commissioner, 34 B. T. A. 791; John Thomas Smith *v.* Commissioner, *supra*, 40 B. T. A. 387.

14 18 B. T. A. 1225, a rehearing affirmed May 26, 1932, unpublished.

15 Helvering *v.* Wilshire Oil Co., 308 U. S. —, No. 1, October Term 1939, decided November 6, 1939.

16 Cf. Sanford *v.* Commissioner, 308 U. S. —, No. 34, October Term 1939, decided November 6, 1939.

17 48 Stat. 680, 691. "Sec. 24. Items not Deductible.

"(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * * *

"(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstand-

deduction for losses determined by sales to corporations controlled by the taxpayer is convincing proof that the law was formerly otherwise. This does not follow. At most it is evidence that a later Congress construed the 1932 Act to recognize separable taxable identities between the taxpayer and his wholly owned corporation. As the new provision goes much farther than the former decisions in disregarding transfers between members of the family it may well have been passed to extend as well as clarify the existing rule. The suggestion is not sufficiently persuasive to give vitality to a futile transfer.

The taxpayer has preserved two objections to the district judge's rulings on the evidence. He claims that evidence as to transactions between the taxpayer and the corporation which took place prior to the sale here involved was remote and highly prejudicial. We think it apparent that this evidence was entirely relevant to the present issue; the history of the taxpayer's relations with the corporation shed considerable light on the actual effect of the sale in question. The second contention is that the district judge charged the jury to give less effect to the book entries of Smith and the corporation than they were entitled to under the applicable book entry statute.[18] The alleged departure from the statute has but dubious support in the record, resting on a single statement of the judge lifted from its context as part of an extended colloquy with counsel. In the circumstances there is no merit in the claim of prejudice to the taxpayer.

The judgment of the Circuit Court of Appeals is reversed and that of the District Court affirmed.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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ing stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

[18] 49 Stat. 1561, 28 U. S. C. § 695.

SUPREME COURT OF THE UNITED STATES.

No. 146.—October Term, 1939.

Joseph T. Higgins, Collector of Internal Revenue for the Third District of New York, Petitioner, *vs.* John Thomas Smith.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[January 8, 1940.]

Mr. Justice Roberts.

I think the judgment should be affirmed. To reverse it is to disregard a rule respecting the separate entity of corporations having basis in logic and practicality and which has long been observed in the administration of the revenue acts.

Since the inception of the system of federal income taxation, capital gains have been taxed and certain capital losses have been allowed as credits against such gains. In order that this system might be practical it has been necessary to select some event as the criterion of realization of gain or loss. The revenue laws have selected the time of the closing of a capital transaction as the occasion for reckoning gain or loss on a capital asset. A typical method of closure is a sale ~~of the~~ asset.

As the sale is voluntarily made by the taxpayer, his determination when he shall sell affects his capital gain or loss. He, therefore, in a sense, controls the question whether, in a given taxable year, he must pay tax on a realized gain or may claim credit for a realized loss. Of course such a sale must be bona fide and title must pass absolutely. In the present instance the sale and transfer were such, and, as the Circuit Court of Appeals held, there was not a scintilla of evidence to the contrary for the jury's consideration. A taxpayer who pretends he has made a sale when in fact he has a secret agreement which leaves him still, for all practical purposes, the owner of the thing sold, is but committing a fraud upon the revenue.

If the sale is bona fide, if title in fact passes irrevocably to another, that other takes as his basis, in reckoning his gain and loss,

the price he paid for the asset; and upon his future disposition of it there will be a new reckoning of gain or loss with respect to such disposition. Here, if Innisfail either sold to the respondent or to a third party it would have to reckon gain or loss on the sale. If it distributed the asset in liquidation the respondent would be subject to a tax liability on the receipt of his dividend. The sole question, then, is whether, as matter of law, a bona fide and absolute sale to a wholly owned corporation can constitute a completed transaction, determining a loss.

The problem as to how a sale to a corporation wholly owned or wholly controlled by an individual taxpayer is to be treated is not a new one. The existence of such corporations and the dealings between them and their stockholder or stockholders have long been understood. Congress was not ignorant of the problem.[1] At the outset Congress might well have adopted the policy that a sale by the stockholder to the corporation, or vice versa, should be disregarded, and the stockholder treated as in effect the owner of the capital asset until its sale to a stranger. On the other hand, it would be a practical policy to recognize the separate entity of the corporation, to treat a transfer at current value for adequate consideration occurring between it and its sole stockholder as closing a transaction for the purpose of reckoning either gain or loss, and then to tax the vendee upon his or its gain or loss upon a subsequent transfer by comparison of the basis on which the asset was acquired and the amount realized on final disposition by the vendee. In fact, the latter course was adopted and was consistently followed until 1934 when Congress dealt with the subject.

This court, speaking by Mr. Justice Holmes, said, in *Klein* v. *Board of Supervisors*, 282 U. S. 19, 24: " . . . But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."

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[1] The Revenue Act of 1932, c. 209, 47 Stat. 169, 196, § 112(b)(5), provided: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; . . . "

In this view assets received on the liquidation of a one-man corporation constitute taxable income to the sole stockholder.[2] Likewise, losses sustained by a corporation wholly owned by one individual may not be reported and claimed in the individual tax return of the latter.[3] And the sole stockholder and his controlled corporation may not tack successive periods of ownership to make up the two years required for an asset to become, within the meaning of the statute, a capital asset.[4]

This court has found that a taxable gain was realized in a case where a wholly owned corporation sold securities to its sole stockholder.[5] Every element appearing in that case is paralleled here, as a comparison of the facts stated in the opinions in the two cases will demonstrate. This court said, in the earlier case, referring to the corporation: "The fact that it had only one stockholder seems of no legal significance," and held the corporation a separate taxable entity. It is now said, however, that there is no inequity in not applying the same rule to losses as to gains because the taxpayer who exercises the option to conduct a portion of his business through the instrumentality of a wholly owned corporation does so in the full knowledge that, if he does, gains shown on sales by him to the corporation will be taxed whereas losses on such sales will not be allowed as deductions. As hereafter will be shown, this is now true in virtue of the amendment embodied in the Revenue Act of 1934 but it was not true as the law stood before the adoption of that amendment.

In 1921 the Treasury was first called upon to deal with a loss deduction arising out of a sale to a wholly owned corporation. In that year it published Law Opinion 1062.[6] It was held that if the sale was bona fide and passed title absolutely to the controlled corporation, even though the sale was made with the intent of reducing the tax liability of the vendor it fell within the provisions of the revenue act concerning the reckoning of gain or loss upon a closed transaction. So far as I am informed, the Treasury followed this rule in administering the various revenue acts for years after it was issued. The first evidence of a change in its position was the

[2] France Co. v. Commissioner, 88 F. (2d) 917; Coxe v. Handy, 24 F. Supp. 178; John K. Greenwood, 1 B. T. A. 291.

[3] Dalton v. Bowers, 287 U. S. 404; Merrill v. Commissioner, 79 F. (2d) 304.

[4] Webber v. Knox, 97 F. (2d) 931.

[5] Burnet v. Commonwealth Improvement Co., 287 U. S. 415.

[6] 4 C. B. 168, cited with approval in G. C. M. 3008 VII-1 C. B. 235.

refusal of the Commissioner of Internal Revenue to recognize losses resulting to taxpayers from a bona fide sale of bonds owned by them to a wholly owned corporation at the current market price.[7] The Board of Tax Appeals sustained the Commissioner, but the Court of Appeals of the District of Columbia reversed the Board in *Jones v. Helvering,* 71 F. (2d) 214. The decision was rendered April 23, 1934. The Commissioner sought certiorari which was denied October 8, 1934.[8] The same result has been reached by three other Circuit Courts of Appeal.[9] The Board of Tax Appeals followed these decisions.[10] In the meantime the Circuit Courts of Appeal had decided numerous cases which are, in principle, indistinguishable.[11] This court having denied certiorari in *Jones* v. *Helvering, supra,* decided *Gregory* v. *Helvering,* 293 U. S. 465, in the following January. It cited the *Jones* case with approval, at p. 469, saying: ". . . The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

So well settled had the judicial interpretation become that the Treasury determined to recommend that Congress amend the statute.[12] The result was the adoption of Sec. 24(a) (6) of the Revenue Act of 1934.[13] The Committee reports disclose that Congress thought it necessary to change the statute in order to render nondeductible a loss claimed on a sale to a wholly owned or a controlled corporation.[14] Subsequent hearings before the Joint Commission

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7 Jones *v.* Commissioner, 18 B. T. A. 1225 (1930).

8 293 U. S. 583.

9 Commissioner *v.* Eldridge, 79 F. (2d) 629 (C. C. A. 9); Commissioner *v.* McCreery, 83 F. (2d) 817 (C. C. A. 9); Helvering *v.* Johnson, 104 F. (2d) 140 (C. C. A. 8); Foster *v.* Commissioner, 96 F. (2d) 130 (C. C. A. 2); Smith *v.* Higgins (the instant case), 102 F. (2d) 456 (C. C. A. 2).

10 David Stewart, 17 B. T. A. 604; Corrado & Galiardi, Inc., 22 B. T. A. 847; Ralph Hochstetter, 34 B. T. A. 791; John Thomas Smith, 40 B. T. A. 387, involving prior years of the taxpayer in this case.

11 Iowa Bridge Co. *v.* Commissioner, 39 F. (2d) 777; Taplin *v.* Commissioner, 41 F. (2d) 454; Commissioner *v.* Van Vorst, 59 F. (2d) 677; Marston *v.* Commissioner, 75 F. (2d) 936; St. Louis Union Trust Co. *v.* United States, 82 F. (2d) 61; Sawtell *v.* Commissioner, 82 F. (2d) 221; Commissioner *v.* Edward Securities Co., 83 F. (2d) 1007, affirming 30 B. T. A. 918.

12 In the Hearings before the Joint Committee on Tax Evasion and Avoidance, 1937, p. 206, it appears that the Solicitor General considered the law so well settled that he refused to apply for certiorari in the Eldridge case, *supra*, note 9, although the Treasury recommended such action.

13 48 Stat. 680, 691.

14 See the report of the Committee on Ways and Means of the House of Representatives, H. R. 704, 73d Cong., Second Sess., p. 23; Senate Report 558, 73d Cong., Second Sess., p. 27; see also the hearings before the Committee on Ways and Means, Revenue Revision, 1934, p. 134.

on Tax Evasion and Avoidance, 1937, p. 207, indicate the same understanding on the part of the Bureau of Internal Revenue and of Congress that the rule of law in effect prior to the adoption of the amendment in 1934 was changed by that legislation. The amendment lists among items not deductible the following:

"(6) Loss from sales or exchanges of property, directly or indirectly, (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per centum in value of the outstanding stock. For the purpose of this paragraph—(C) an individual shall be considered as owning the stock owned, directly or indirectly, by his family; and (D) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

Plainly, prior to 1934, taxpayers were justified in relying, first, upon the Treasury ruling on the subject and, secondly, upon the uniform decisions of the courts in claiming deductions for losses on sales to controlled corporations. After the passage of the amendment they were on notice that this was no longer permissible.

I turn then to the situation here presented. The claims of this taxpayer, as I have said, had been sustained for prior years by the Board of Tax Appeals.[15] The Congress had enacted that subsequent to 1934 the taxpayer could not claim such losses. Notwithstanding the earlier decisions of the respondent's case and those of other taxpayers against the Government's present contention, the Commissioner of Internal Revenue, *after* the adoption of the Act of 1934, namely on March 11, 1935, served a notice of deficiency upon the respondent respecting losses claimed in his return for the year 1932 on sales to Innisfail. Thus the Treasury repudiated the position it had taken in asking that the law be amended to cover cases of this kind; reversed its position in acquiescing in the adjudication of the respondent's tax liability for earlier years and sought, now that it had obtained an amendment of the law operating prospectively, to reach back into sundry unclosed ones,—this one amongst others,—and to attempt to obtain decisions reversing the settled course of decision. I think this court should not lend its aid to the effort.

I am of opinion that where taxpayers have relied upon a long unvarying series of decisions construing and applying a statute,

[15] *Supra*, Note 10.

the only appropriate method to change the rights of the taxpayers is to go to Congress for legislation. In my view, the resort to Congress, on the one hand, for amendment, and the appeal to the courts, on the other, for a reversal of construction, which, if successful, will operate unjustly and retroactively upon those who have acted in reliance upon oft-reiterated judicial decisions, are wholly inconsistent.

I am of opinion that the courts should not disappoint the well-founded expectation of citizens that, until Congress speaks to the contrary, they may, with confidence, rely upon the uniform judicial interpretation of a statute. The action taken in this case seems to me to make it impossible for a citizen safely to conduct his affairs in reliance upon any settled body of court decisions.

Mr. Justice McReynolds joins in this opinion.